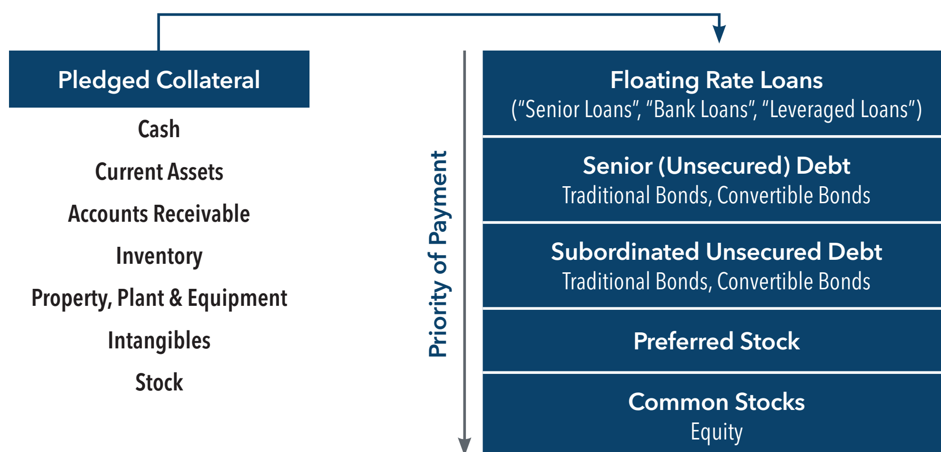
# The Case for Loans

SYMPHONY ASSET MANAGEMENT

**MARKET COMMENTARY**

FEBRUARY 2016

**WHAT ARE FLOATING RATE LOANS?** Also commonly referred to as "senior secured loans" or "bank loans", floating rate loans are made by large commercial or investment banks to generally below-investment grade corporations for the purpose of financing operations. These loans are underwritten, syndicated and sold to institutional investors including but not limited to institutions, insurance companies, hedge funds and investment companies (mutual funds). Senior secured loans are made to both private and public companies and sit atop the corporate capital structure. This means that in the event of financial distress, senior secured loan holders are the first to be paid back before all other holders of securities in the capital structure. Senior secured debt is generally backed by various forms of collateral at the firm, ranging from cash to inventory to property, plant and equipment.




## Key Attributes

Several key attributes and characteristics of bank loans may make the asset class attractive. Most notably, they are a floating rate asset.

| Feature | Explanation | Attributes |
|---|---|---|
| **Senior** | Loans are typically the most senior debt of non-investment grade companies | Highest priority of claim in event of default |
| **Secured** | Loans are typically secured by assets, such as property, equipment, intellectual property, accounts receivable and inventories | Assets can be transferred to loan holder in cases of default<br>Helps to mitigate downside risk |
| **Floating Rate** | Loan coupons float based on a variable interest rate such as LIBOR. Loans are issued with a coupon that pays a predetermined rate above the variable rate | As rates rise, loan coupons reset and provide investors with higher income payments<br>Reduces interest rate risk |


NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

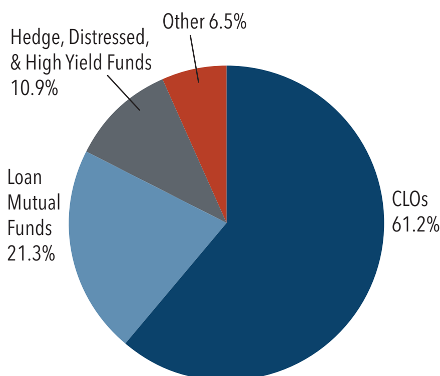
Bank loans offer a coupon that generally floats and is comprised of two parts; a fixed "spread" and a variable reference rate. The most commonly used reference rate is the 90-day LIBOR (London Interbank Offered Rate). The bank loan coupon in this case will pay a fixed spread, such as 3.5%, in addition to the 90-day LIBOR (for example 1.0%) for a total of 4.5% and will adjust every time the LIBOR rate adjusts (e.g. every 90-days in this case). Thus, if LIBOR increases to 1.5% at the end of the 90-day period, the loan coupon will adjust up to 5.0% for the next successive 90-day period. The benefit of this dynamic is that income from floating rate loans increases when short-term rates rise, and loan prices ultimately exhibit low sensitivity to rising interest rates.[1]

## History of the Loan Asset Class

The bank loan asset class has evolved materially over the last 20 years. Prior to the early 1990s, bank loans were generally held solely by large commercial banks. However, as the market evolved and more institutional buyers became interested in the asset class, the large banks moved to syndicating the loans they held and selling them to institutional buyers, including pensions, foundations, endowments and insurance companies as well as professional investors managing structured vehicles known as collateralized loan obligations (CLOs), hedge funds and mutual funds. Today, the ownership of bank loans continues to be a diversified mix dominated by institutional investors and, to a lesser extent (roughly 22%), retail mutual funds. This dynamic tends to provide stability to the asset class because of the longer-term investment horizon for many holders of bank loans. Bank loans have drawn tremendous interest over the last decade and a half, and today the institutional loan market represents nearly $1 trillion of invested capital.

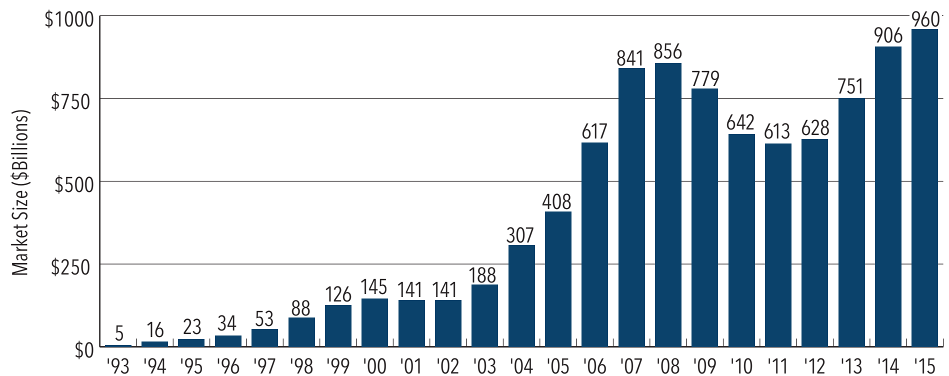
**BANK LOANS HAVE DRAWN TREMENDOUS INTEREST** over the last decade and a half and today the institutional loan market represents nearly $1 trillion of invested capital.

**Exhibit 1:**
**Leveraged Loan Market Investor Base**




Data source: S&P Capital IQ LSD as of 12/31/15.

**Exhibit 2:**
**Leveraged Loan Market Size: Institutional Facilities**




Data source: Credit Suisse, LPC from 1/1/93 to 12/31/15. Includes U.S.-Dollar denominated non-investment grade fully-drawn institutional term loans (TLb's, TLc's, TLd's, etc).

1 Loan interest rates may not rise in this scenario if the loan has a LIBOR (or other benchmark) floor feature.

## Why Should an Investor Consider Bank Loans?

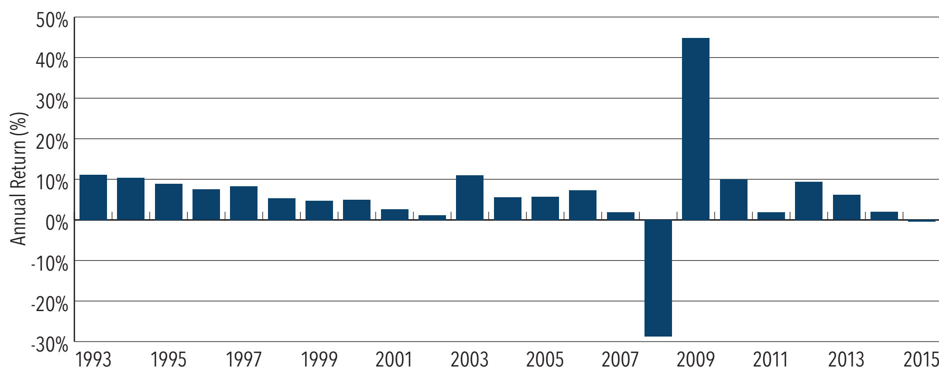
- Attractive coupon and source of income
- Lower interest rate sensitivity
- Low correlation to other asset classes
- Potential for strong performance during rising rate environments
- Senior position in the capital structure, resulting in lower default rates and higher recovery value than bonds from the same company

In addition to being senior in the capital structure, bank loans include a floating rate income component that reacts relatively quickly to rising rates, and when coupled with the ever-evolving depth of the market buyer base, the bank loan asset class offers other compelling reasons to be invested.

Over its limited history, the loan asset class has offered relatively consistent returns under most market conditions with only two negative calendar year returns since its inception.

The loan asset class has offered **CONSISTENT RETURNS** under most market conditions with only two negative calendar year returns since its inception.

### Exhibit 3: Annual Returns of Credit Suisse Leveraged Loan Index




Data source: Credit Suisse from 1/1/93 - 12/31/15. **Past performance is no guarantee of future results.** Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. See Glossary for index definitions.

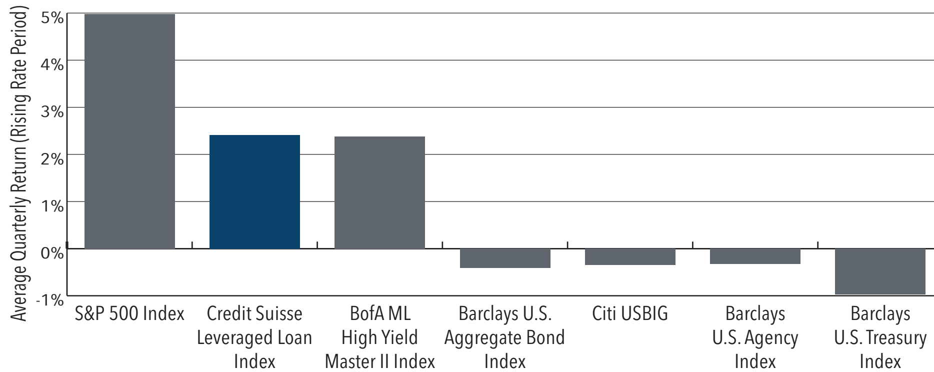
While loans have provided positive returns under most market conditions, in 2008 concerns about the impact of the global financial crisis caused loan prices to fall. The result was heavy forced selling and increased risk aversion by banks, institutional and mutual fund investors, leading to a large drop in loan prices. As these risks and concerns subsided, the asset class experienced a dramatic recovery — followed in subsequent years by returns which have been more consistent with prior history.

Importantly, during periods of rising rate environments, the bank loan asset class has provided compelling returns, outpacing all other rate-sensitive fixed income sectors.

In addition to being senior in the capital structure, loans produce **INCOME WHICH INCREASES WHEN SHORT-TERM RATES RISE.**

### Exhibit 4: Average Quarterly Return (Rising Rate Period)

Common Inception – April 1, 1992 to December 31, 2015

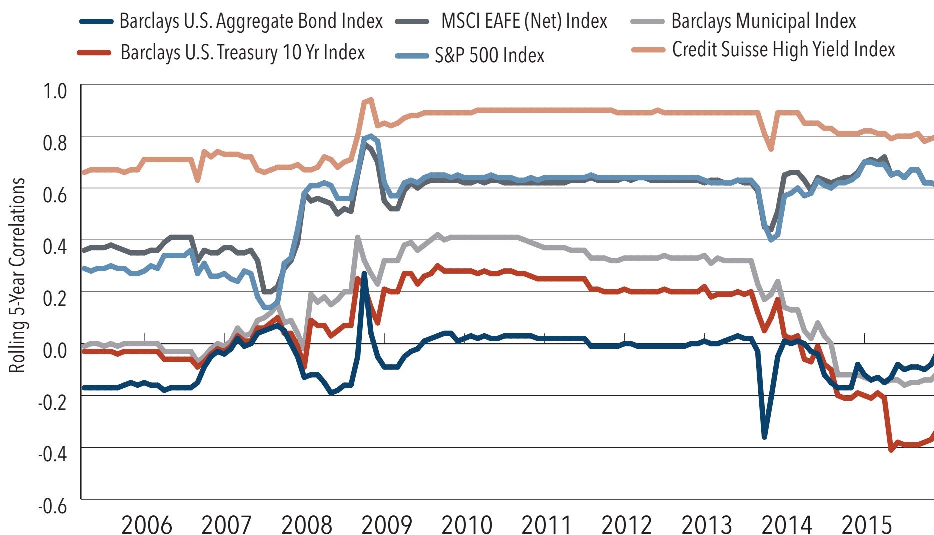



Data source: Morningstar Direct from 4/1/92 - 12/31/15. **Past performance is no guarantee of future results.** Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. See Glossary for index definitions.

While it is important to remember that most bank loan issuers are below-investment grade corporations and carry with them additional credit risk, the asset class offers compelling diversification benefits. When comparing bank loans to more interest rate sensitive asset classes, you find little to no correlation. In addition, while loans have higher correlations to equities than investment grade bonds, their average correlation of 0.60[2] over the past ten years provides potential diversification relative to equities as well.

**WHEN COMPARING BANK LOANS** to interest rate sensitive asset classes, you find little to no correlation.

### Exhibit 5: Rolling 5-Year Correlations of Credit Suisse Leveraged Loan Index vs. Major Asset Classes



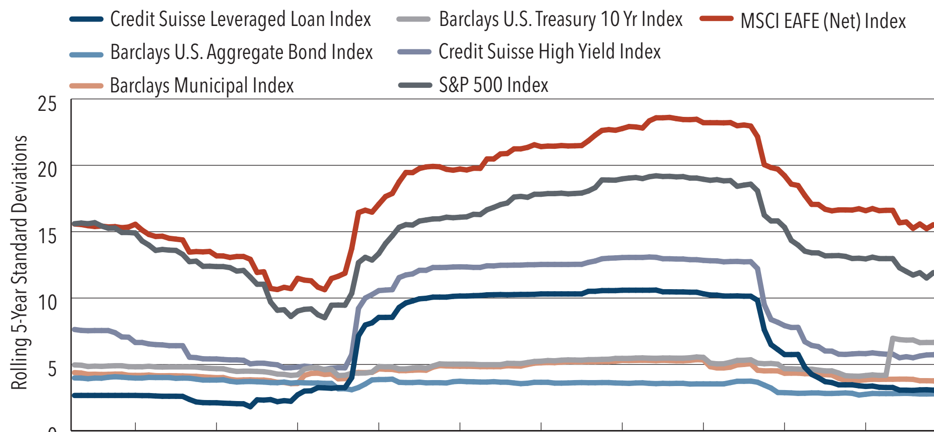

Data source: Morningstar Direct from 5/1/05 - 12/31/15. **Past performance is no guarantee of future results.** Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. See Glossary for index definitions.

2 Data source: Morningstar Direct from 1/1/06 - 12/31/15. 10-year correlation of the Credit Suisse Leveraged Loan Index to the S&P 500® Index.

## What Are the Risks?

To first understand risk, it is worth examining the standard deviation and risk profile of the bank loan asset class versus both other major fixed income sectors and asset classes. When looking at 5-year rolling standard deviations, the bank loan asset class has exhibited a greater risk profile than investment grade fixed income sectors and a lower risk profile to both below-investment grade corporate bonds and equities.

**Exhibit 6: Rolling 5-Year Standard Deviations of Major Asset Classes**




Data source: Morningstar Direct from 4/30/05 - 12/31/15. **Past performance is no guarantee of future results.** Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. See Glossary for index definitions.

**THE BANK LOAN ASSET CLASS** has exhibited a greater risk profile than investment grade fixed income sectors and lower risk profile to both below-investment grade corporate bonds and equities.

But, with any investment comes various sources of risk, and it is important to spell out a few key risks associated with the bank loan asset class:

a. **Credit risk or Default risk** — While senior in structure, bank loans issued by below-investment grade corporations face a higher degree of default risk, which is the risk that a borrower may be unwilling or unable to pay interest or principal. The prices of loans can also be affected by market perceptions of credit risk, falling when perceived risk rises and rising when perceived risk falls.

b. **Structure risk** — While bank loans sit atop the capital structure and most loans are secured, some loans are not secured by collateral and in the event of default may not recover as much as secured loans.

c. **Liquidity risk** — The bank loan asset class trades as an over-the-counter or negotiated market and is therefore subject to more liquidity risk during periods of greater risk aversion. In addition, because bank loans are technically not a "security", settlement of transactions in loans generally takes longer — sometimes significantly longer — than securities which settle in three days or fewer.

d. **Call risk** — Borrowers can "call" their loans and repay them at any time (similar to how a homeowner can repay their loan at any time). This dynamic generally occurs more frequently when rates are falling and financing costs are thus declining and a borrower can refinance a loan at a lower rate.

## Conclusion

The bank loan asset class has evolved materially over the last 20 plus years and has become an important source of funds for many below-investment grade corporations. Not only has the size of market grown but the breadth of investors has increased as the result of several attractive characteristics, including: income which increases when rates rise, low correlation to other asset classes and attractive returns when short-term rates rise. Of course, investing in loans does not come without risks — the most important of which is the credit risk of the specific issuer. Therefore, selecting a manager with strong, bottom-up research capabilities is key when considering investing in this asset class. ■

## For more information, please contact your financial advisor or visit nuveen.com.

### GLOSSARY

The **Barclays Municipal Index** covers the USD denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The **Barclays U.S. Agency Index** includes native currency agency debentures from issuers such as Fannie Mae, Freddie Mac, and Federal Home Loan Bank. It is a subcomponent of the Government-Related Index (which also includes non-native currency agency bonds, sovereigns, supranationals, and local authority debt) and the U.S. Government Index (which also includes U.S. Treasury debt). The index includes callable and non-callable agency securities that are publicly issued by U.S. government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government (such as USAID securities).

The **Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double counting.

The **Barclays U.S. Treasury Bellwethers 10 Yr. Index** is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The **BofA Merrill Lynch High Yield Master II Index** tracks the performance of U.S. Dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The **CITI U.S. Broad Investment-Grade Bond Index (USBIG)** tracks the performance of US Dollar-denominated bonds issued in the US investment-grade bond market. Introduced in 1985, the index includes US Treasury, government sponsored, collateralized, and corporate debt providing a reliable representation of the US investment-grade bond market. Sub-indices are available in any combination of asset class, maturity, and rating.

**Correlation** is a statistical measure of how two securities move in relation to each other. Perfect positive correlation (a correlation co-effi cient of +1) implies that as one security moves the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation (a correlation co-effi cient of -1) means that securities will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; their movements in relation to one another are completely random. Indices are unmanaged and unavailable for direct investment.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loans are added to the index if they qualify according to the following criteria: The highest Moody's/S&P ratings are Ba1/BBB+, only funded term loans are included, and the tenor must be at least one year.

The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The **S&P 500® Index** measures the performance of large capitalization U.S. stocks. The S&P 500® is a market weighted index of 500® stocks that are traded on the NYSE, AMEX and NASDAQ.

**Standard deviation** is a measure of the degree to which a fund's actual returns varied from its average return over a certain period. The smaller the variation, the lower the standard deviation will be. The standard deviation is a common measure of volatility and risk.

### RISKS AND OTHER IMPORTANT CONSIDERATIONS

This information represents the opinion of Symphony Asset Management, LLC and is not intended to be a forecast of future events and this is no guarantee of any future result. It is not intended to provide specific advice and should not be considered investment advice of any kind. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell specific securities or investment products. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage.

Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

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